Current Economic Conditions

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Cathy Minehan
President & CEO,
Federal Reserve Bank of Boston
Overview

• U.S. recovery is now on a solid footing
  – Self-generated private growth is substituting for policy-induced growth
  – Employment growth has picked up, while productivity growth remains strong
  – Inflation requires watching, but likely to remain well-behaved

• New England fared worse than the nation, but the regional outlook is improving
The recovery has gained steam

- Consumption spending has been strong
- Investment in equipment and software has picked up
- And recent data point to continued strength in both consumption and investment
The recovery has gained steam, and has featured strong private spending.
Recent indicators of consumer spending suggest continued strength this year.

Investment spending will likely grow at a solid double-digit pace.

Consumption is supported by rising income growth

• Consumption depends upon “disposable” or after-tax income
• Earlier, tax cuts were responsible for most of the growth in disposable income
• Now, income is growing on its own
Earlier tax cuts spurred growth in household income. Now pre-tax income is improving.

Household net worth is also improving

• Improving financial markets and rising home prices have boosted households’ net worth

• Corporate cash flow is also growing strongly, providing support to business investment
Financial markets have provided support …

… Boosting Household Net Worth and Improving Corporate Cash Flow

More broadly, policy-induced growth is being replaced by private spending

We expect the recovery to be increasingly privately-driven. The effect of tax refunds will wane later this year, and financial markets see the Fed raising rates soon.

Source: Federal Funds Target Rate (%): Federal Reserve Board.
Labor Markets are Improving
Layoffs have been declining for a while

And Now Hiring Appears to Have Turned the Corner

Employment and hours have shown significant improvement

As productivity growth has receded to merely spectacular rates of growth

Is inflation an issue?

• Some commodity prices have risen sharply
• Core inflation has edged up, although still low
• Is this cause for worry? Probably not
Trend inflation is probably still well-contained

Much of the recent rise in core inflation is pass-through of oil prices and other one-time price increases

Restraining forces on inflation: Corporate Profit Growth Has Been Strong

Nonfarm business profits, after tax, including IVA and CCADJ

And Profit Margins are High

Unit profit, nonfinan. corporate business, including IVA and CCADJ

Source: Corporate Profits After Tax with IVA and CCAdj (SAAR, Billions $), Corporate Profits with IVA and CCAdj per Unit of Real Gross Value Added of Nonfinancial Corporate Business (SA): Bureau of Economic Analysis.
Restraining forces on inflation: Economic slack is likely to persist for another year or so, whether measured by employment or output.

Graph showing Nonfarm employment and Private employment over time from 1999:Jan to 2004:Jan.

Graph showing the estimate of “output gap” (Actual GDP less potential) from 1997:Q1 to 2005:Q1.

Risks

• **Inflation** – likely to remain low; risks fairly balanced
  – Recent increases largely due to one-time factors
  – Significant economic slack remains

• **Real growth** – likely to remain solid; risks fairly balanced
  – As tax cuts fade, we expect strong employment growth to create income, support spending
  – Some uncertainty about employment forecast
  – Some uncertainty about geopolitical situation
What About Deficits?
Federal budget deficit/surplus as % of GDP, with OMB projections

Source: Federal Deficit/Surplus as a Percent of GDP (Fiscal year, %): Office of Management and Budget.
Deficits are a long run concern, not a near term problem

- Will deficits cause inflation?
  - Still have some economic slack despite growth in federal spending
  - Our forecasts for next few years indicate solid growth, fairly stable inflation, and a declining deficit/GDP ratio

- Will deficits crowd out investment?
  - Long term interest rates should already reflect what we know about the path of deficits
  - Near-term outlook for investment is positive
How is New England faring?

• Suffered greater employment losses than the nation in the recession; losses continued in the “recovery”
• Turnaround is beginning – slower than nationally
• Within the region, some states are doing much better than others
Employment has fallen more in New England than the Nation

Index, Pre-Recession Peak = 1

But weakness is much less severe than early 1990s (dotted lines)

Considerable variation among the New England states – Massachusetts hit hardest, Rhode Island showing minimal job losses

Why is New England faring worse?

• Steeper losses in recession attributable to national weakness in key regional industries:
  – software and other technology services
  – communications
  – computers and other capital goods

• Steadier sectors important in New England, such as private education and health services, not strong enough to offset
In past year, manufacturing, information and professional services lost jobs; Gains in construction and hospitality

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For all New England, job losses have moderated

Unemployment is coming down in the region

Percent, Seasonally Adjusted

United States

New England

Confidence is rising in New England
Index of leading indicators for Massachusetts points to growth

Source: Associated Industries of Massachusetts and the University of Massachusetts.
Key factor in regional outlook continues to be national economy, but New England lags

• Regional recovery will continue, following nation
• Pace of region’s recovery is contingent on national (and global) economy → hence regional pace likely to speed up
Boston Fed Experience

• According to our own HR department,
  - recent falloff in job applicants
  - less desperation, more negotiation
  - counter-offers and turndowns
• “The tide is turning”